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December 16, 2003

RE: 03-124 On behalf of Pegasus Communications

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th St., N.W.
Washington, DC 20544

Dear Ms. Dortch

On December 15, 2003, Cheryl Crate of Pegasus Communications, Kevin Lefton of Wallman Consulting, LLC and I, of the same consulting firm, met with Jordan Goldstein of Comm. Copps' office and Jennifer Manner of Comm. Abernathy's office. In each of those meetings we discussed the following topics and concerns.

We are concerned that the conditions currently contemplated in connection with approval of the purchase by the FOX Entertainment Group (an 81% owned subsidiary of the News Corporation) of a controlling interest in Hughes Electronics Corporation will not constrain disruptive programming price manipulation by FOX to the detriment of: (i) distributors of DIRECTV programming (such as Pegasus) who are contractually obligated to pay their pro rata share of DIRECTV's programming costs; (ii) multichannel video program distributors (MVPD's) that are not affiliated with FOX who must negotiate licensing and/or re-transmission consent agreements with FOX or its affiliates; and (iii) consumers of multichannel video programming.

It is our understanding that the only condition that would act to constrain FOX's manipulation of program license agreements that the Commission is considering is the creation of a non-binding arbitration mechanism for FOX owned regional sports programming and for retransmission consent agreements with FOX owned and/or affiliated local TV stations. Unfortunately, the potential for anti-consumer carriage and pricing decisions by FOX extends well beyond regional sports and local TV retransmission agreements. That risk cannot therefore adequately be prevented merely by the availability of arbitration. The market moves much faster to define winners and losers than an arbitration proceeding can address. In a market where approval of a combination that boosts bargaining and market power as substantially as in this case, this should be of the gravest concern.

Why should the Commission be concerned about the possibility that Fox will raise prices for services like Fox News to DirecTV?

Because doing so will give FOX cover, under its proffered commitment to offer nondiscriminatory terms of carriage to other MVPD's, to raise prices to other MVPD's on a take it or leave it basis. The result of this manipulation will be higher prices to all subscribers of distribution systems that decide (as many will do) that FOX programming is "must have" programming that is necessary to attract and keep their subscribers against the competitive threat of DIRECTV. While DIRECTV will be disadvantaged by such non-arms length pricing, FOX (which will own only 34% of DIRECTV, but owns 100% of FOX programming) will clearly be better off. Unfortunately, competitive MVPD's and consumers will be substantially worse off, as well.

Why would Fox exert such manipulation?

There are two reasons. One reason is pursuit of the classic strategy of raising rivals' costs in the downstream distribution market by increasing input prices over which the producer, FOX, exerts control. The second reason is in pursuit of an overall profit maximization strategy at the parent level, in the course of which the parent, FOX, can fine-tune choices about programming prices in the upstream market and distribution prices in the downstream market to achieve this strategy.

How would Fox execute this strategy?

Here is an example. Say FOX is charging $.50 per subscriber per month for FOX News, and that this is the price, hypothetically, charged today both to DIRECTV and Echostar. Assume that the day after the transaction is consummated, FOX informs DIRECTV and Echostar that the price will be increased to $.70 per subscriber per month. If both parties agree to carry the service at the new price, FOX has increased its programming revenue by 40% on that service. This strategy would be worthwhile to FOX if 34% of the *reduction* in DIRECTV's profitability (FOX will own 34% of DIRECTV upon consummation of this transaction) is *less than* 100% of the *increase* in FOX's profitability. This will certainly be true if Echostar were to accept the new terms for FOX News. Importantly, it may *also* be true if Echostar does not accept the proposed pricing and loses subscribers to DIRECTV because it does not offer FOX programming. The operational impact of these decisions is in line with the predictions and observations of classical economic theory on the behavior of vertically integrated entities.

Why does Pegasus care about these manipulations?

Pegasus is an independent distributor of DIRECTV programming. Therefore we will be subject to any programming increases to which DIRECTV agrees. Programming costs are our largest single cost element, representing more than 50% of our total revenues. Non-competitive programming cost increases due to non-arms length agreements between FOX and DIRECTV will therefore have the potential to significantly diminish our profitability and thereby undermine our ability to compete with other MVPD's. In this respect, Pegasus lacks even the basic protection that Echostar and other MVPD's have of refusing to accept unjustified increases in the cost of FOX programming.

What should the Commission do?

We understand that the Commission is not actively considering the most important of the conditions that we previously proposed in the record, which would be to establish a third-party benchmark for pricing increases. We understand that the Commission's reluctance has to do with the difficulty of crafting an enforceable benchmark. While we do not see the difficulty of such a comparison on a per-subscriber basis, we are prepared to suggest other conditions within the framework of what the Commission appears prepared to consider:

1. A majority of the independent directors of DIRECTV's (and Hughes Electronics Corporation's) board of directors must approve programming agreements with FOX and all FOX affiliates. "Independent" would have the same meaning as under current SEC and exchange listing rules. Only independent approval can ensure that the programming increase is being accepted for reasons that make sense for DIRECTV, and not as part of a profit maximizing strategy at the parent level.
2. Likewise, a majority of the independent directors of DIRECTV's (and Hughes Electronic's) board of directors must approve decisions to decline to carry programming services that compete with FOX programming services.
3. The independent directors, as well as the CEO and CFO, of DIRECTV (and Hughes Electronics Corporation) must certify annually to the FCC that they have complied with these conditions.
4. With respect to the proposed arbitration mechanism, insofar as we understand it:
    a. The arbitration process should extend to: (i) licensing negotiations between FOX and non-vertically owned MVPD's who compete with DIRECTV; and (ii) licensing negotiations between DIRECTV and non-vertically owned programmers who compete with FOX. Arbitration should NOT be limited to just regional sports programmers and local retransmission consent partners.
    b. Distributors of DIRECTV (such as Pegasus) must be granted explicit standing to participate in such proceedings where they would be adversely affected by programming carriage and pricing decisions.
    c. The arbitration process should be binding and streamlined.
    d. The arbitration process could be invoked by any aggrieved party, and would be automatically triggered if:
        i. Any proposed increase for FOX programming is 25% greater than the overall programming increase agreed to by DIRECTV for non-FOX owned, non-vertically owned programming;
        ii. Any proposed increase for FOX programming offered to DIRECTV would exceed by 25% the most recent year's charge by FOX to DIRECTV for such programming.

In view of the cycle of retransmission consent renewals, we urge that the FCC keep these supervisory conditions in place for six years.

The FCC should not underestimate the increased market power that FOX will wield if its purchase of control of DIRECTV is approved. The revised conditions we propose are the minimum necessary to protect competition in the multichannel video market. Without them, while the News Corporation and its shareholders will benefit significantly, programmers competing with FOX, MVPD's competing with DIRECTV, distributors of DIRECTV (such as Pegasus) who must accept non-arms length prices for FOX programming and, most importantly, consumers will all stand to lose much more. For these reasons, we strongly urge their adoption.

Very truly yours,

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Kathleen Wallman